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ABSTRACT

An Earned Income Tax Credit (EITC) is a tax reduction and a wage supplement for low- and moderate-income working families. The federal government, and some states, administer an EITC through the income tax. States that enact EITCs can reduce child poverty, support welfare-to-work efforts, and cut taxes for families struggling to make ends meet. This report focuses on: (1) "The Problem: Poverty Despite Work"; (2) "Helping Make Work Pay: The Federal Earned Income Tax Credit"; (3) "Why Enact a State Earned Income Tax Credit?" (federal EITC does not lift all working families out of poverty, and state EITCs lift additional families out of poverty, complement welfare reform, and provide needed tax relief); (4) "Designing a State Earned Income Tax Credit" (refundable versus nonrefundable EITCs, setting the size of a state EITC, adjustments for family size, and workers without qualifying children); (5) "Financing a State Earned Income Tax Credit" (estimating the cost of a refundable state EITC and financing state EITCs through the Temporary Assistance for Needy Families Block Grant); and (6) "Enacting a State Earned Income Tax Credit: Case Studies." Two appendixes include the federal EITC parameters and the estimated cost of refundable state EITCs. (SM)

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A HAND UP

How State Earned Income Tax Credits Help Working Families Escape Poverty 2000 Edition

Nicholas Johnson

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Author

Nicholas Johnson is a senior policy analyst with the Center on Budget and Policy Priorities' State Fiscal Project. He has authored several reports on tax relief for low-income families and other state budget and tax issues.

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Center on Budget and Policy Priorities
820 First Street, N.E., Suite 510
Washington, DC 20002
(202) 408-1080

E-mail: center@cbpp.org
Web: www.cbpp.org

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The author is solely responsible for the contents of this report.

A HAND UP

How State Earned Income Tax Credits
Help Working Families Escape Poverty
2000 Edition

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Center on Budget and Policy Priorities
Washington, D.C.

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Executive Summary

An Earned Income Tax Credit is a tax reduction and a wage supplement for low- and moderate-income working families. The federal government administers an EITC through the income tax. So do a rising number of states. States that enact EITCs can reduce child poverty, support welfare-to-work efforts, and cut taxes for families struggling to make ends meet.

Rising Number of States Offer EITCs

In the 2000 legislative session, nine states (counting the District of Columbia as a state) enacted new Earned Income Tax Credits or expanded existing state EITCs. The District of Columbia, Illinois, Maine, and New Jersey enacted new EITCs. Colorado, Maryland, Minnesota, New York, and Vermont substantially expanded existing EITCs.

Altogether, 15 states now offer EITCs based on the federal credit.[1] Such credits have gained support across the political spectrum. EITCs have been enacted in states led by Republicans, in states led by Democrats, and in states with bipartisan leadership. The credits are supported by business groups as well as by social service advocates.

[1] A 16th state, Indiana, in 1999 enacted an "earned income tax credit" that is quite different from the federal credit; the Indiana credit is discussed briefly on page 17. In addition, one local government – Montgomery County, Maryland – offers a local EITC discussed on page 24.

Why Consider an EITC?

Several developments explain the popularity of state EITCs in the late 1990s.

- *Continued child poverty.* Despite the current economic expansion, some 8.4 million children in working families remain poor. State EITCs can help reduce poverty among families with children.

- *Welfare reform.* Over the last six years, several million welfare recipients have left welfare and entered the workforce. Many of them, however, cannot make ends meet on their earnings alone. Even with recent increases in the federal minimum wage, a full-time job often is not sufficient to lift a family out of poverty. State EITCs support families who enter and remain in the workforce.

- *Tax cuts.* A number of states are responding to strong fiscal conditions by enacting tax cuts. Enacting a state EITC is a way to ensure that low- and moderate-income families share in the benefits of those tax cuts. This is particularly important because most state tax systems rely heavily on regressive sales, excise, and property taxes. Moreover, nearly half of the states impose an income tax on working-poor families. A state EITC can help offset those taxes.

State Earned Income Tax Credits Based on the Federal Credit

Refundable credits
Colorado
District of Columbia
Kansas
Maryland
Massachusetts
Minnesota
New Jersey
New York
Wisconsin
Vermont

Non-refundable credits
Illinois
Iowa
Maine
Oregon
Rhode Island

Why Model a State Credit on the Federal EITC?

The federal EITC was established in 1975 to offset the effects of federal payroll taxes on low-income families. It has been expanded several times since, providing additional assistance to welfare recipients entering the workforce and other workers supporting their families on low wages. Support for the EITC has come from across the political spectrum.

The effectiveness of the federal EITC both in supporting work and in alleviating child poverty has been confirmed by a number of recent studies.

- The EITC now lifts nearly 5 million people — roughly half of them children — out of poverty each year; it is the nation's most effective antipoverty program for working families.

- In addition, recent research shows that the credit has contributed to a significant increase in labor force participation among single mothers.

- Interviews with EITC recipients show that many use their EITC refunds to make the kinds of investments — paying off debt, investing in education, securing decent housing — that enhance economic security and promote economic opportunity.

Designing a State EITC

Fourteen state EITCs piggyback on the federal EITC; those 14 states use federal eligibility rules and express the state credit as a specified percentage of the federal credit. (The percentages are shown in Table 1.) The fifteenth state with an EITC, Minnesota, also uses federal eligibility rules, and its credit parallels major elements of the structure.

Ten of the 15 states with EITCs follow the federal practice of making the credit "refundable." This means a family receives the full amount of its credit even if the credit amount is greater than its income tax liability. The amount by which the credit exceeds annual income taxes is paid as a refund. If a family has no income tax liability, the family receives the entire EITC as a refund. All low-income working families with children can participate in a refundable EITC. Refundable credits are offered in Colorado, the District of Columbia, Kansas, Maryland, Massachusetts, Minnesota, New Jersey, New York, Wisconsin, and Vermont.

The remaining five credits are non-refundable — that is, each credit is available only to the extent that it offsets a family's income tax. A non-refundable EITC can provide substantial tax relief to families with state income tax liability, but it provides no benefits to working families that have income too low to owe any income taxes. Thus a non-refundable credit assists somewhat fewer working-poor families with children and is likely to be less effective as a work incentive. Non-refundable credits are presently offered in Illinois, Iowa, Maine, Oregon and Rhode Island.

Financing a State Credit

The annual cost of refundable state EITCs in tax year 1996 ranged from $12 million in Vermont to $291 million in New York. The cost of a state EITC depends principally on four factors: the number of families in a given state that claim the federal credit, the percentage of the

federal credit at which the state credit is set, whether the credit is refundable or non-refundable, and how many state residents that receive the federal credit also learn about and claim the state credit. Because state EITCs are better targeted to low- and moderate-income working families than many other major tax cuts, the cost may be relatively modest. A relatively straightforward procedure for estimating the cost of a refundable credit in any state is set forth on pages 27 to 29 of this report.

Most state credits to date have been financed from funds available in a state's general fund — the same funding source typically used for other types of tax cuts. New federal regulations, however, offer the opportunity to finance a portion of the cost of a refundable credit from a state's share of the federal Temporary Assistance to Needy Families block grant. Whether general funds or block-grant funds are the most appropriate funding stream to use to finance the credit will depend on a number of factors, including the specifics of a state's budget situation, the amount of unallocated TANF funds or "maintenance of effort" funds available to the state, and the state's priorities for use of TANF funds. No matter how it is financed, however, an EITC can complement a state's welfare program by assisting low-income working families with children.

Table 1
State Earned Income Tax Credits
Based on the Federal EITC, Tax Year 2000

State	Percentage of Federal Credit
Refundable credits:	
Colorado	10%
District of Columbia	10%
Kansas	10%
Maryland*	15%
Massachusetts	10% (rising to 15% in 2001)
Minnesota	25% to 45%, depending on earnings
New Jersey**	10% (rising to 20% by 2003)
New York	22.5% (rising to 30% by 2003)
Vermont	32%
Wisconsin	4% — one child 14% — two children 43% — three children
Non-refundable credits:	
Illinois	5%
Iowa	6.5%
Maine	5%
Oregon	5%
Rhode Island	26%

*Maryland also offers a non-refundable EITC set at 50 percent of the credit. Low- and moderate-income taxpayers in effect may claim either the refundable credit or the non-refundable credit, but not both.
**The New Jersey credit is available only to families with incomes below $20,000.
Center on Budget and Policy Priorities

I. The Problem: Poverty Despite Work

It is common to believe that most poor families with children include parents who could work but do not. Yet this is not an accurate picture of poor families in the United States. To the contrary, work is the norm among poor families with children.

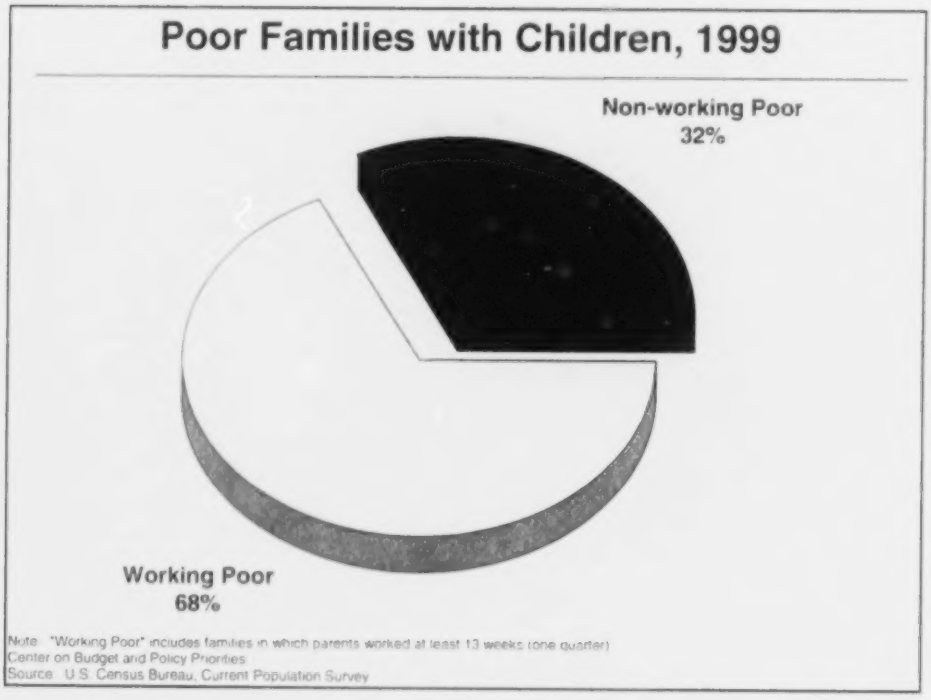
- In 1999, some 4.8 million families with children in which the parents were not elderly or disabled had incomes below the federal poverty line.[2] Of these families, 3.2 million — or 68 percent — included at least one working parent.

- Some 12.5 million people — including 7.3 million children — lived in a working-poor family in 1999. In 2000 dollars, that means living on an income of less than about $13,700 for a family of three or about $17,600 for a family of four.

- Among all poor families with children in which one or both parents were employed at any time during the year, the parents worked a combined average of 41 weeks throughout the year, or nine and one-half months.

- Even among families that received welfare income at some point in 1999 — either TANF cash assistance, SSI, or general assistance — 66 percent had a parent who worked part of the year. This includes families that used public assistance when a parent's job was lost, families that left welfare when a parent found work, and families in which a parent worked but remained eligible for welfare due to low earnings.

[2] An additional 600,000 poor families had parents who were ill, elderly or disabled, and thus were not able to work.


Poor Families with Children, 1999
Non-working Poor
32%
Working Poor
68%
Note: "Working Poor" includes families in which parents worked at least 13 weeks (one quarter)
Center on Budget and Policy Priorities
Source: U.S. Census Bureau, Current Population Survey

The problem of poverty despite work has grown substantially over the past two decades. The poverty rate among all workers, including those without children, was seven percent higher in 1999 than in 1979. (A comparison of these two years is appropriate because they were at similar points in the economic cycle and had similar unemployment levels.) Even more dramatically, during that time, the poverty rate rose 31 percent among families with children in which the household head worked.[3]

[3] The poverty rate for all workers rose from 5.7 percent in 1979 to 6.1 percent in 1999. The poverty rate for working families with children rose during that time from 7.7 percent to 10.1 percent.

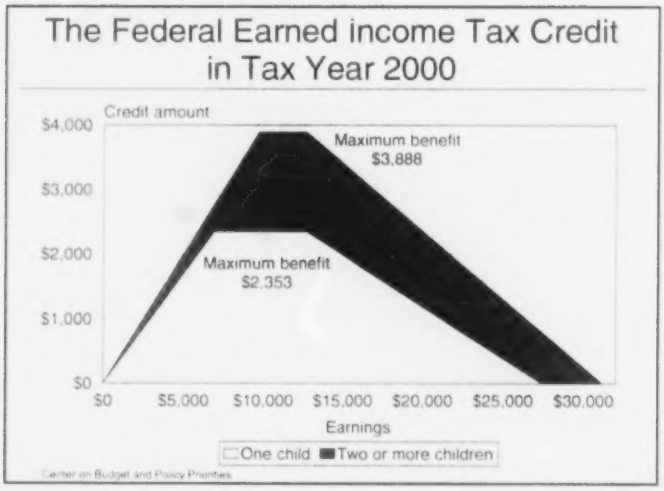
II. Helping Make Work Pay: The Federal Earned Income Tax Credit

The federal EITC is a tax credit for low- and moderate-income workers, primarily those with children, designed to offset the burden of Social Security payroll taxes, supplement earnings, and complement efforts to help families make the transition from welfare to work. The EITC was enacted in 1975 primarily as a means of tax relief; for a decade, the credit received little attention and was not altered significantly. Starting in the mid-1980s, however, the EITC was expanded three times, in 1986, 1990, and 1993.[4] Through these expansions, the EITC became a central element of federal efforts to boost income from work and lessen poverty among families with children, often called the "make work pay" strategy. Support for the EITC has come from across the political spectrum, with conservatives such as former President Ronald Reagan among its strong supporters.

The maximum EITC benefit in 2000 is $3,888 for families with two or more children and $2,353 for families with one child. The greater EITC benefit for larger families reflects a recognition that larger families face higher living expenses than smaller families. Workers without a qualifying child also may receive an EITC, but the maximum credit for individuals or couples without children is $353 in 2000, much lower than the credit for families with children.

The actual EITC benefit that an eligible family receives depends on the family's income. For families with very low earnings, the value of the EITC *increases* as earnings rise. For example, families with two or more children receive an EITC equal to 40 cents for each dollar up to $9,720 earned in 2000, for a maximum benefit of $3,888. Families with one child receive an EITC equal to 34 cents for each dollar earned up to $6,920 of earnings, for a maximum benefit of

[4] The 1993 increase was phased in through tax year 1996. Since 1996, EITC benefit and eligibility levels have not been increased beyond automatic cost-of-living adjustments.



$2,353. Both types of families continue to be eligible for the maximum credit until income reaches $12,690.[5]

For families with incomes above $12,690 in 2000, the EITC phases out as earnings rise. Families with two or more children are eligible for some EITC benefit until income exceeds $31,152, while families with one child remain eligible for some EITC benefit until income exceeds $27,413. Figure 1 shows the EITC benefit structure for families with children. The exact parameters for tax years 2000 and 2001 are shown in Appendix I.

For tax year 1998, about 19.8 million U.S. families and individuals claimed the federal EITC. Table 2 shows state-by-state participation levels.

The federal EITC is a *refundable* credit, which means that if the credit amount is larger than a family's income tax bill, the family receives a refund check. This refundability allows families to take full advantage of the credit even if they owe little or nothing in federal income taxes, as is the case for most poor working families.

Because the EITC is administered through the tax code, most recipients claim the credit when they file an income tax form. Families also have the option to receive a portion of their EITC benefit throughout the year with each paycheck, although few families exercise that option.

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[5] The average benefit for a family with one child in tax year 1998 was about $1,500; for a family with two or more children, the average credit was $2,300.

Table 2
Number of Families and Individuals That Received the EITC for Tax Year 1998

State	EITC Recipients	State	EITC Recipients
Alabama	443,441	Montana	65,948
Alaska	30,833	Nebraska	94,016
Arizona	342,692	Nevada	125,729
Arkansas	250,174	New Hampshire	56,003
California	2,373,809	New Jersey	446,071
Colorado	235,744	New Mexico	179,459
Connecticut	146,219	New York	1,302,422
Delaware	49,796	North Carolina	642,853
District of Columbia	52,638	North Dakota	36,849
Florida	1,283,199	Ohio	687,933
Georgia	702,954	Oklahoma	283,049
Hawaii	67,211	Oregon	202,177
Idaho	83,836	Pennsylvania	692,596
Illinois	753,848	Rhode Island	58,782
Indiana	364,171	South Carolina	373,985
Iowa	148,997	South Dakota	48,174
Kansas	146,827	Tennessee	479,331
Kentucky	303,911	Texas	1,879,486
Louisiana	475,701	Utah	108,892
Maine	80,815	Vermont	36,032
Maryland	324,565	Virginia	441,337
Massachusetts	280,285	Washington	311,202
Michigan	562,121	West Virginia	138,238
Minnesota	217,542	Wisconsin	249,342
Mississippi	343,825	Wyoming	32,441
Missouri	385,385		

Source: Internal Revenue Service, *SOI Bulletin*, Spring 2000.
Center on Budget and Policy Priorities.

The EITC is available to both single-parent and two-parent families with children. Two-parent families can receive the EITC whether both parents work or whether one parent works while the other parent stays home to care for the children, so long as the family's income is below the EITC limit. In this respect the credit differs from some other tax benefits for working

families, such as the dependent care credit, where only families in which both parents work are eligible for the credit.

How the Federal EITC Achieves Its Goals

The structure of the federal EITC enables it to accomplish several policy goals, as illustrated by the following examples.

- The federal EITC reduces the tax burden on low- and moderate-income families both by offsetting federal income taxes and by offsetting some or all of the federal payroll taxes that finance Social Security and Medicare programs.

  Example One. A single parent with one child, working full time throughout the year at a wage of $9 per hour, earns $18,700 per year. This worker owes $497 in 2000 federal income taxes which are withheld from the paycheck during the year. The family also qualifies for an EITC of $1,393. The EITC allows the family to get back the $497 it paid in income taxes and to receive an additional refund of $895. The EITC refund serves to offset some of the worker's $1,431 in payroll taxes that also were paid during the year.[6]

- For many recipients, especially those just entering the workforce and those with very low earnings, the EITC goes beyond offsetting taxes paid to act as a wage supplement.

  Example Two. A single parent with one child working full-time at the minimum wage of $5.15 per hour earns about $10,700 annually. This worker does not owe any federal income tax, but qualifies for a 2000 EITC of $2,353. The parent pays $819 in payroll taxes, so the EITC refund offsets those taxes and provides an additional $1,534 as a wage supplement.[7]

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[6] The calculations of payroll tax in this analysis do not include the portion of the payroll tax paid directly by the employer that matches the employee's share; the employee and employer each pay 7.65 percent of earnings. Although the employer share of the tax is not reflected in workers' nominal earnings — in this case $9 an hour — economists generally hold that both the employer and employee share of the payroll tax are in effect reductions in employee wages. The history of the EITC indicates it was designed specifically to offset both shares of the payroll tax.

[7] As in the preceding example, the calculation of payroll taxes does not include the employer share of payroll taxes.

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- As a result of recent expansions of the EITC and of 1996 legislation to raise the federal minimum wage, a minimum-wage job plus the EITC provide enough cash income to some families to support a family at a level above the poverty line.

  Without the federal EITC, the full-time minimum-wage worker with one child described above would have after-tax income of $9,881, about $1,300 below the federal poverty line of $11,200. The EITC lifts the family's cash income to $12,234, about $1,100 *above* the poverty line.[5] Similarly, for a single parent of two children with a full-time, minimum-wage job, the EITC is sufficient to lift the family's after-tax earnings above the poverty line.

  For families of four persons or larger, however, a full-time minimum wage job and the EITC together are not sufficient to lift the family from poverty. As discussed below in more detail, a state EITC can help bridge the gap.

These examples also help illustrate the importance of the refundability of the EITC. If it were not refundable, the EITC could not offset payroll taxes — which represent a much larger burden on low-income working families than the income tax — nor serve as a wage supplement to families with little or no income tax liability.

Research evidence confirms that the EITC has been effective at meeting the goals of making work pay better and reducing poverty among working families.

- The wage supplement offered by the EITC has encouraged hundreds of thousands of welfare recipients to enter the workforce. Several academic studies, using a variety of sources of data, show that the EITC more than any other factor accounts for the increase in workforce participation among single mothers over the last 15 years. (See box on page 8.)

- The additional income provided by the EITC in 1999 lifted 4.7 million people out of poverty, including 2.6 million children, who would have been poor without it.

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[5] This calculation reflects earnings of $10,700, minus $819 for the employee share of payroll tax, plus the $2,353 EITC. This income measurement differs from the measurement used by the Census Bureau in its official poverty calculations. The official federal poverty threshold is based on cash income, both earned and unearned, but does not include the value of in-kind benefits or the effects of taxes on disposable income. Nevertheless, many analysts agree that the payroll taxes and EITC benefits should be counted in addition to wages for the purpose of determining how far a family with a full-time minimum wage worker falls below the poverty line.

Research Findings on the Effectiveness of the EITC

Several recent academic studies indicate that the EITC has positive effects in inducing more single parents to go to work, reducing welfare receipt, and moderating the growing income gaps between rich and poor Americans.

Harvard economist Jeffrey Liebman, who has conducted a series of studies on the EITC, has noted that workforce participation among single women with children has risen dramatically since the mid-1980s.[a] In 1984, some 72.7 percent of single women with children worked during the year. In 1996, some 82.1 percent did. The increase has been most pronounced among women with less than high school education. During this same period there was *no* increase in work effort among single women *without* children.

A number of researchers have found that the large expansions of the EITC since the mid-1980s have been a major factor behind the trend toward greater workforce participation. Studies by Liebman and University of California economist Nada Eissa find a sizable EITC effect in inducing more single women with children to work.[b] In addition, a recent study by Northwestern University economists Bruce Meyer and Dan Rosenbaum finds that a large share of the increase in employment of single mothers in recent years can be attributed to expansions of the EITC. They find that the EITC expansions explain more than half of the increase in employment among single mothers over the 1984-1996 period. Of note, Meyer and Rosenbaum found evidence that *state* EITCs also contributed to workforce participation increases in the states where credits were available.[c]

These findings are consistent with an earlier study by Stacy Dickert, Scott Hauser, and John Karl Scholz of the University of Wisconsin, which projected that the EITC expansions in the 1993 budget law would generate a reduction in welfare receipt. Dickert, Hauser, and Scholz estimated that the 1993 EITC expansions would induce approximately 500,000 families to move from welfare to the workforce.[d]

Finally, Liebman also has found that the EITC moderates the gap between rich and poor. During the past 20 years, the share of national income received by the poorest fifth of households with children has declined, while the share of income received by the top fifth has risen sharply. Liebman found that the EITC offsets between one-fourth and one-third of the decline that occurred during this period in the share of income the poorest fifth of households with children receive.

A discussion of these and other studies on the EITC's effectiveness may be found in the Center on Budget and Policy Priorities publication *New Research Findings on the Effects of the Earned Income Tax Credit*, March 16, 1998.

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[a] Jeffrey B. Liebman, "The Impact of the Earned Income Tax Credit on Incentives and Income Distribution," in James M. Poterba, ed., *Tax Policy and the Economy, Vol. 12*, MIT Press, 1998.

[b] Nada Eissa and Jeffrey B. Liebman, "Labor Supply Response to the Earned Income Tax Credit," *Quarterly Journal of Economics*, May 1996, 112(2), pp. 605-637

[c] Bruce D. Meyer and Dan T. Rosenbaum, "Welfare, The Earned Income Tax Credit, and the Labor Supply of Single Mothers," September 1999, and "Making Single Mothers Work," October 1, 1999.

[d] Stacy Dickert, Scott Hauser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," in James M. Poterba, ed., *Tax Policy and the Economy, Vol. 9*, MIT Press, 1995.

according to Census Bureau data. The EITC lifts more working families out of poverty than any other government program.[9]

- Families can use their EITCs to make investments that may over the long term reduce their dependence on government benefits. In 1996, a team of researchers from Syracuse University and the Center for Law and Human Services surveyed close to 1,000 EITC recipients. Over half of those surveyed spent some or all their EITC refunds on the kinds of financial investments or human capital investments that are likely to increase earnings or to protect against future economic shocks such as loss of a job. Those investments included paying for tuition or other education expenses, increasing access to jobs through car repairs and other transportation improvements, moving to a new neighborhood, or putting money in a savings account.[10]

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[9] See the Center on Budget and Policy Priorities publication *Strengths of the Safety Net: How the EITC, Social Security, and Other Government Programs Affect Poverty*, March 1998.

[10] Timothy M. Smeeding, Katherin E. Ross, Michael O'Connor and Michael Simon, "The Economic Impact of the Earned Income Tax Credit: Consumption, Savings, and Debt," 1999.

III. Why Enact a State Earned Income Tax Credit?

State Earned Income Tax Credits can further the goals of the federal EITC by bringing working families closer to or above the poverty line. And just as the federal EITC helps offset *federal* taxes paid by low-income working families, state EITCs can help relieve the substantial burden of *state and local* taxes levied on working-poor families in every state.

Federal EITC Does Not Lift All Working Families Out of Poverty

Despite the success of the federal EITC in reducing poverty among working families, wages plus the EITC do not guarantee an escape from poverty for all families. Even many families with a full-time, year-round worker remain poor. Other families with working parents remain poor because parents are unable to find full-time, year-round employment.

- Full-time, year-round work, even at wages above the minimum wage, is not always sufficient to bring a family above the poverty line even after the federal EITC is taken into account.

  Example Three. A family of four with two or three children and a full-time, year-round worker earning $7.00 per hour — well above the current federal minimum wage — has earnings of about $14,600 per year. After subtracting the employee share of payroll taxes and adding the 2000 EITC for which the family qualifies of $3,486, the family's cash income equals $16,969, or about $500 below the poverty line for a family of four.

If the worker earned the minimum wage instead of $7 per hour, or if the family had five or more members, the "poverty gap"— the amount by which income falls short of the poverty line — would be several thousand dollars.[11]

- Many low-wage working parents are unable to work every day of the year or are unable to work full-time. Census Bureau data indicate that in 1997 nearly half of the working parents in poor families with children — 1.8 million working-poor parents — either worked part-time because they could not find full-time work or spent a portion of the year unemployed. In addition to economic factors, many parents lose earnings when they take unpaid leave to fulfil their child-rearing responsibilities. Families in which parents work less than full time or less than all year can fall into poverty even if they receive the federal EITC and even if the parent earns above the minimum wage.

  Example Four. A single parent with two children working nearly full-time — 50 weeks per year at 38 hours per week — at the minimum wage of $5.15 per hour has an annual income of about $9,800. After subtracting payroll tax and adding the $3,888 federal EITC for which that family qualifies, the family's cash income totals $12,938, or about $700 below the 2000 poverty line for a family of three.[12] If the parent works fewer weeks in the year or fewer hours per week, the poverty gap is larger.

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[11] This estimate of the "poverty gap" and the one that follows do not include the value of food stamps, which are nearly equivalent to cash, because most working-poor families do not receive food stamp benefits. For example, just 28 percent of poor families with children with a full-time worker received food stamps in 1998. The low rate of food stamp participation partly reflects the fact that many working-poor families do not meet the program's somewhat stringent asset limits, including a limit on the value of a family car. In addition, some eligible families do not apply for food stamps, in part because they face barriers to participation such as a limited number of food stamp offices and limited hours of operation at these offices.

For some families that receive food stamps, the EITC plus the cash value of food stamps can lift them above the poverty line. But for others, the EITC and food stamps are not enough. For instance, earnings from a full-time job at the current federal minimum wage of $5.15 an hour in 2000 are insufficient to lift the income of a family of four above the poverty line even counting both the EITC and the value of food stamps.

[12] This example does not include cash assistance a family may receive either while working or unemployed. In a majority of states, such a family would be ineligible for cash assistance while the parent is working. If the parent received cash assistance during a period of unemployment, the typical state's welfare benefits would fail to make up for the lost wages, leaving the family well below poverty for the year.

State EITCs Lift Additional Families Out of Poverty

State EITCs can build on the success of the federal EITC in combating poverty among working families with children. Closing or at least substantially reducing the poverty gap for many working families, such as the families described in the examples above, is well within the reach of most states.

- The family of four earning $14,600 per year described in Example Three above falls about $500 below the federal poverty line even with the federal EITC. A state EITC equal to 15 percent of the federal EITC would lift the family's income above the poverty line.

- The family of three with annual earnings of $9,800 described in Example Four falls about $700 below the poverty line. A state EITC equal to 20 percent of the federal EITC would lift that family's income above the poverty line.

The details of how such state EITC programs work are described in Chapters IV and V beginning on page 17.

State EITCs Complement Welfare Reform

The use of state EITCs to enable low-wage workers to escape poverty is of particular relevance to state welfare reform efforts. Many welfare recipients that take jobs continue to have very low incomes, often below poverty. Recent evidence from several states shows that although most welfare recipients who find jobs are employed close to full-time, many of them earn wages at or only slightly above the minimum wage. Moreover, many do not qualify for paid vacation or sick leave, forcing them to take unpaid leave for reasons such as a child's illness. A number of studies show that welfare recipients who find jobs typically earn $2,000 to $3,000 per quarter, or $8,000 to $12,000 per year; many earn less.[13] Earnings in that income range are insufficient to lift a single-parent family of three above the poverty line even with the federal EITC. A combination of the federal EITC *and* a state EITC, however, can close the poverty gap for many welfare recipients as they move into the workforce.

States have demonstrated a strong policy interest in subsidizing the efforts of welfare recipients to enter and remain in the workforce. For example, the vast majority of states have adopted "enhanced earnings disregards" in their welfare programs, under which welfare benefits

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[13] See U.S. General Accounting Office, *Welfare Reform: Information on Former Recipients' Status*, April 1999; Sarah Brauner and Pamela Loprest, *Where Are They Now? What States' Studies of People Who Left Welfare Tell Us*, Urban Institute, May 1999; and Sharon Parrott, *Welfare Recipients Who Find Jobs: What Do We Know About Their Employment and Earnings?*, Center on Budget and Policy Priorities, November 1998.

phase out gradually as family earnings increase, thereby helping ease the transition from welfare to work. Many states also have expanded access to child care and to health insurance for working-poor families.

States also have an interest in supporting the work efforts of low- and moderate-income families who have left the welfare rolls or who have never received welfare benefits. EITCs help meet the ongoing expenses associated with working — such as transportation — and may allow families to cope with unforeseen costs that otherwise might drive them onto public assistance.

Federal policies encourage the use of a state EITC to assist families as parents enter the workforce and to support the work efforts of lower-income families. The federal rules for the Temporary Assistance to Needy Families program, the welfare block grant to states enacted in 1996, allow the refundable portion of state EITCs to be financed with federal TANF funds or with the "maintenance of effort" funds states must spend to access the federal TANF funds. Using TANF or MOE funds to help finance state EITCs is discussed in greater detail in Chapter V.

State EITCs Provide Needed Tax Relief

In addition to reducing poverty among working families, state EITCs can play an important role in providing relief from state and local taxes paid by low-income working families, just as the federal EITC serves to relieve the burden of payroll taxes on such families. In every state, low-income working families pay a substantial share of their income in state and local taxes. State EITCs thus can help ensure that state tax systems do not push poor working families deeper into poverty.

Reducing the Income Tax

In 1999, income taxes were levied on below-poverty families in 20 of the 42 states with a personal income tax. On average in the states that imposed a tax on poor families of four, families began owing tax when income reached $11,600, roughly $5,500 below the 1999 poverty line. The average tax burden in these states was $219 for a family of four with earnings at the poverty line.[14] (See Table 3.)

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[14] Center on Budget and Policy Priorities, *State Income Tax Burdens on Low-Income Families in 1999: Assessing the Burden and Opportunities for Relief*, March 2000. This report is updated annually.

Table 3
State Income Tax Thresholds for Two-Parent Families of Four, 1999

Poverty line (estimated): $17,028

Rank	State	Threshold
1	Alabama	$4,600
2	Kentucky	5,200
3	Illinois	6,600
4	Virginia	8,200
5	Montana	9,100
6	Indiana	9,500
7	New Jersey	10,000
7	West Virginia	10,000
9	Hawaii	11,000
10	Michigan	11,800
11	Ohio	12,300
12	Louisiana	12,700
12	Oklahoma	12,700
14	Missouri	13,900
15	Oregon	14,400
16	Georgia	15,300
17	Utah	15,500
18	Arkansas	15,600
19	Delaware	16,100
20	North Carolina	17,000
Average Threshold 1999		**$11,575**
Amount Below Poverty		**$5,453**

Rank	State	Threshold
21	Iowa	$17,300
22	District of Columbia	18,200
22	South Carolina	18,200
24	Idaho	18,400
25	Mississippi	18,600
25	Nebraska	18,600
27	North Dakota	18,700
28	Wisconsin	18,800
29	Maine	20,200
30	Massachusetts	20,500
31	New Mexico	20,600
32	Kansas	20,900
33	New York	23,000
34	Arizona	23,600
35	Connecticut	24,100
36	Colorado	24,600
37	Maryland	24,800
38	Rhode Island	25,400
38	Vermont	25,400
40	Minnesota	26,000
40	Pennsylvania	26,000
42	California	35,500
Average Threshold 1999		**$22,155**
Amount Above Poverty		**$5,127**

Note: A threshold is the lowest income level at which a family has state income tax liability. In this table thresholds are rounded to the nearest $100. The 1999 poverty line is a Census Bureau estimate based on the actual 1998 line adjusted for inflation. The threshold calculations include earned income tax credits, other general tax credits, exemptions, and standard deductions. Credits that are intended to offset the effects of taxes other than the income tax or that are not available to all low-income families are not taken into account.

Source: Center on Budget and Policy Priorities

Offsetting Sales, Excise and Property Taxes

While the personal income tax burden on poor families is notable in many states, other parts of state and local tax codes often contribute even more to the tax burden on poor families. Most states rely to a large extent on revenue from sales and excise taxes. These taxes are regressive, which means they absorb a much larger proportion of the incomes of lower-income households than of higher-income households. In 1995, the average state and local tax burden on the poorest fifth of married, non-elderly families was 12.5 percent of income. By contrast, the wealthiest one percent of such families spent an average of 7.9 percent of income for state and local taxes.[15] Sales and excise taxes alone accounted for half of the state and local tax burden on the poorest families.

Changes in state tax systems in the early and mid-1990s have increased the need to provide tax relief for low-income residents. In many states, taxes were raised in the early 1990s in response to the recession and were reduced more recently as the economy improved. The net effect of these changes was to push state tax systems in a more regressive direction.

- In the early 1990s, as many states experienced recession-induced fiscal crises, 43 states raised taxes to balance their budgets. Nearly half of the additional revenues came from regressive sales and excise taxes.

- Many states have cut taxes in recent years in response to the strong economy, but they generally have not reversed the sales and excise tax increases of the early 1990s. Less than one percent of the net state tax cuts enacted from 1994 through 1997 were reductions in sales and excise taxes.[16] Sales and excise tax cuts since 1997 have been similarly modest.

Because sales and excise taxes fall heavily on low-income residents, the increases in sales and excise taxes in many states are likely to have increased the tax burden on working-poor families in many states. State EITCs could serve to offset recent increases in taxes on low-income families in many states.

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[15] Citizens for Tax Justice and the Institute on Taxation and Economic Policy, *Who Pays?: A Distributional Analysis of the Tax Systems in All 50 States*, June 1996, Appendix I, p. 52.

[16] For more information see Nicholas Johnson and Iris Lav, *Are State Taxes Becoming More Regressive?*, Center on Budget and Policy Priorities, October 29, 1997.

IV. Designing a State Earned Income Tax Credit

Fifteen states (counting the District of Columbia as a state) have state EITCs that build on the strengths of the federal EITC. Table 4 describes the structures of the 15 existing state EITCs that are based on the federal credit.

A sixteenth state, Indiana, created a tax credit in 1999 for working-poor families with children that is called an "Earned Income Tax Credit." However, the Indiana credit differs substantially from the federal EITC and from other state EITCs in its income eligibility rules and its benefit structure.[17]

Fourteen state EITCs piggyback fully on the federal EITC; these 14 states use federal eligibility rules for families with children and express the state credit as a specified percentage of the federal credit. The fifteenth state, Minnesota, follows federal eligibility rules but does not express its credit as a percentage of the federal credit. For families with children, the Minnesota

[17] Specifically, the Indiana credit is available only to families with income below $12,000. Moreover, unlike the federal credit, the amount of the Indiana credit declines rather than increases as a parent enters the workforce and increases his or her earnings. An additional state, Virginia, passed legislation in 1998 to create a new non-refundable tax credit based in part on the federal EITC. However, the legislation provided that the credit would take effect only if the U.S. Department of Health and Human Services certified that the cost of the credit could be counted as part of the "maintenance of effort" spending Virginia must make in order to receive federal Temporary Aid to Needy Families block grant funds. The Department of Health and Human Services declined to issue that certification on the grounds that the credit was non-refundable and therefore would not qualify as an "expenditure" under the TANF regulations. As a result of the letter, that tax credit did not take effect. Instead, Virginia in 2000 enacted a different credit that offsets income tax liability for families with incomes below the poverty line.

Table 4
State Earned Income Tax Credits Based on the Federal EITC, Tax Year 2000

State[a]	Percentage of Federal Credit	Workers Without Qualifying Children Eligible?
Refundable credits:		
Colorado[b]	10%	Yes
District of Columbia	10%	Yes
Kansas	10%	Yes
Maryland[c]	15%	No
Massachusetts	10% (rising to 15% in 2001)	Yes
Minnesota[d]	Average 29% (rising to 33% in 2001)	Yes
New Jersey[e]	10% (rising to 20% by 2003)	No
New York[f]	22.5% (rising to 30% by 2003)	Yes
Vermont	32%	Yes
Wisconsin	4% — one child 14% — two children 43% — three children	No
Non-refundable credits:		
Illinois	5%	Yes
Iowa	6.5%	Yes
Maine	5%	Yes
Oregon	5%	Yes
Rhode Island[g]	26%	Yes

Notes.

[a] In addition to the 15 states shown here, a 16th state, Indiana, has enacted a refundable tax credit for working-poor families with children described in statute as an "earned income tax credit." Unlike the tax credits listed in this table, the Indiana credit is unavailable to a large portion of the recipients of the federal credit.

[b] The Colorado credit automatically will be suspended in any year should state revenues fall below a certain level. Such a suspension would occur only with a substantial fall in revenue from 2000 levels.

[c] Maryland also offers a non-refundable EITC set at 50 percent of the credit. Low- and moderate-income taxpayers in effect may claim either the refundable credit or the non-refundable credit, but not both.

[d] Minnesota's credit for families with children, unlike the other credits shown in this table, is not expressly structured as a percentage of the federal credit. Depending on income level, the credit for families with children may range from 22 percent to 46 percent of the federal credit; taxpayers without children may receive a 15 percent credit. Beginning in tax year 2001, the credit for all taxpayers will range from 25 percent to 45 percent of the federal credit and will average 33 percent of the federal credit.

[e] The New Jersey credit is available only to families with incomes below $20,000.

[f] The New York credit will be reduced automatically to the 1999 level of 20 percent should the federal government reduce New York's Temporary Assistance to Needy Families block grant.

[g] Rhode Island's credit is phasing down to 25 percent of the federal credit over five years as part of an overall reduction in the state income tax.

benefit structure is slightly different from the structure of federal credit; families in Minnesota use a separate tax table in their state tax forms to determine their EITC amount. (See box on page 20 for discussion of the Minnesota EITC.)

An EITC that piggybacks on the federal credit is relatively easy for a state to administer and also is easy for families claiming the EITC. To determine its state EITC benefit, a family need only write its federal benefit on its state return and then multiply the federal amount by the state EITC percentage.

A state that chooses to piggy-back on the federal credit has four decisions to make for designing a state EITC.

- Should the credit be refundable or non-refundable? That is, will taxpayers be able to receive the credit even if they have little or no state income tax liability?
- At what percentage of the federal credit will the state credit be set?
- Will low-income workers without children, who presently receive a small federal credit, be eligible for the state credit?
- Will the state credit be adjusted for family size?

Each of these decisions will affect the cost of the credit; financing a state credit is discussed in the next chapter.

Refundable Versus Non-Refundable EITCs

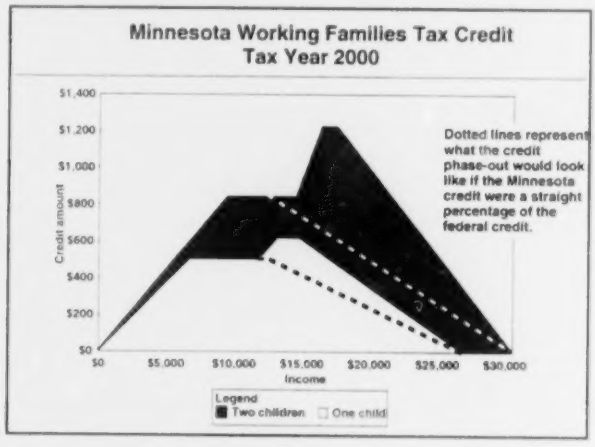
If a state EITC is refundable, a family receives a refund check if the size of its EITC exceeds its tax bill. For example, if a taxpayer owes $80 in state income taxes and qualifies for a $200 state EITC, the first $80 of the EITC offsets the income tax and the remaining $120 is received as a refund check. (If the $80 of income tax were withheld during the year, the taxpayer would receive the entire $200 as a check. Nevertheless, the EITC would offset $80 in tax liability and provide a $120 income supplement.)

If the credit were non-refundable, the family's income tax liability would be eliminated. The remaining $120 of the credit, however, would be forfeited.

The distinction between refundable and non-refundable credits is important because families with very low earnings, such as most families moving off welfare, owe little or nothing in state income taxes in many states. These families thus would receive little or no benefit from a non-refundable EITC. Moreover, because it only can offset taxes owed, a non-refundable EITC does not supplement a family's income above its earnings and thus does not lift any families with

Minnesota's EITC Phases Out at Higher Income Levels Than Federal Credit

Until 1998, Minnesota's EITC was set at a straight percentage of the federal credit. But in 1998 the state changed the structure of its state EITC (known as the "Working Families Credit") to respond to a specific concern about the impact of tax and transfer programs on the state's working poor. A 1997 analysis of Minnesota welfare recipients found that an increase in wages or hours beyond full-time minimum-wage work did not necessarily make families better off than they were when earning the minimum wage. The reason was that over certain income ranges, additional earnings were offset by increased taxes and the loss of cash assistance and food stamps. For instance, a single full-time worker with two children earning $6 per hour who received a pay raise to $8 per hour would not have any gain in disposable income after taking into account increased taxes and lost welfare benefits due to the wage increase. This was known as the "no net gain" problem.



The solution was to build into the state EITC an additional phase-in range for families facing the "no net gain" problem. For families with incomes below about $12,000, the Minnesota credit is the same as it would be if it were simply set at 22 percent of the federal credit (25 percent for tax years beginning in 2001). But while the federal credit begins to decline in value as a family's annual income exceeds about $13,000, the Minnesota credit *increases* in value until a family's earnings reach about $13,500 for a family with one child and about $17,000 for a family with two or more children. The credit does not begin to decline in value until a family's income exceeds $15,000 for a family with one child and $18,000 for a family with two children.

The Minnesota credit is not completely decoupled from the federal credit. The credit for workers without children remains set at a flat rate of 15 percent of the federal credit (rising to 25 percent for tax year 2001). Eligibility rules still follow the federal eligibility rules, and the maximum income a family may have to qualify for the credit is the same as the federal maximum.

below-poverty wages out of poverty. A refundable EITC, by contrast, can be used to boost the incomes of low-income working families, including those making the transition from welfare to work, as the federal EITC does. Making a state EITC refundable also allows it to be used to offset sales and excise taxes paid by low-income families. In addition, a refundable credit can be financed in part with federal welfare block-grant funds; this issue is discussed in the next chapter.

The importance of refundability is reflected in the decision of most states to make their EITCs refundable. Ten of the 15 states with a state EITC — Colorado, the District of Columbia, Kansas, Maryland, Massachusetts, Minnesota, New Jersey, New York, Vermont, and Wisconsin — offer refundable credits. The number and value of refundable EITCs have increased in the last four years.

- The new credits enacted in Colorado, the District of Columbia, Massachusetts, New Jersey, and Kansas are refundable.[18]

- Minnesota is substantially expanding its refundable credit for families with children over several years. The credit, which had been set at 15 percent of the federal credit until 1997, will equal 25 to 45 percent of the federal credit depending on family size and income by 2001. The changes more than double the average EITC recipient's state credit.

- Maryland, which previously offered a non-refundable credit that benefitted only those families with incomes above the poverty line, enacted a refundable credit as well. The new, refundable credit is set at 15 percent of the federal EITC.[19]

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[18] The Colorado credit, enacted in 1999, contains a contingency clause under which the credit will be suspended in any year in which state revenues do not exceed the state's constitutional spending limit. According to current fiscal projections, this clause will not cause the credit to be suspended at any time in the foreseeable future, but a sharp revenue reduction — whether due to a downturn in the state's economy or to changes in state tax law — could lead to suspension of the credit.

[19] Maryland taxpayers with children now have the option of choosing either the new, refundable credit or the previously existing non-refundable credit. The non-refundable credit is set at 50 percent; the refundable credit is set at 10 percent of the federal credit, rising to 12.5 percent in tax year 2000 and 15 percent in tax year 2001. Most families with incomes below the poverty line are likely to receive greater benefit from the smaller, refundable credit; most families with incomes above the poverty line are likely to receive greater benefit from the larger, non-refundable credit.

- New York increased its refundable credit from 20 percent to 22.5 percent of the federal credit for tax year 2000, to 25 percent of the federal credit for tax year 2001 to 27.5 percent for tax year 2002, and to 30 percent for tax year 2003.[20]

Among states with new EITCs, only Illinois, Maine, and Oregon enacted non-refundable credits. In each of those states, a refundable version of the credit received bipartisan support but was not enacted due to budget constraints.

Setting the Size of a State EITC

Choosing the percentage of the federal EITC at which the state credit is set should be based on several considerations. One consideration is the cost that can be afforded. Another is the level of state income tax relief desired. A third factor is the size of the desired income boost for poor families that qualify for a refund. The state may wish, for example, to enact a credit that lifts particular types of families above the poverty line.

The EITCs in the states with refundable credits generally range from 10 percent to 30 percent of the federal credit. The two exceptions are the credits in Wisconsin and Minnesota. The Wisconsin EITC ranges from four percent of the federal credit for families with one child to 43 percent of the federal credit for families with three or more children. The Minnesota EITC for families with children, which is structured independently of the federal credit, effectively ranges from 22 percent to 46 percent of the federal credit, averaging about 29 percent (the average will rise to 33 percent due to changes enacted for the 2001 tax year).

Table 5 shows the benefit of a refundable EITC set at 15 percent or 25 percent of the federal credit for various low-income working families. For example, a family of four with two or three children and one minimum-wage worker qualifies for a federal EITC of $3,888 in 2000. If the family lives in a state with a 25 percent state EITC, the family receives a state credit of $972. If the state credit is set at 15 percent of the federal credit, the family's state credit is $583.

Adjustments for Family Size

A state EITC may be designed to provide greater adjustment for family size than is provided by the federal credit. Although the federal EITC provides higher benefits to families with two or more children than to families with one child, it does not fully compensate for the higher cost of living for larger families. The maximum federal EITC for families with two children is about $1,500 higher than for families with one child, while the poverty line for a

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[20] The statute expanding the New York credit provides that the expansion will be rolled back if New York's share of the Temporary Assistance to Needy Families block grant is reduced.

Table 5
Earned Income Tax Credit Amounts by Family Income Levels, 2000

	Gross Earnings	Federal EITC	25% State EITC	15% State EITC
Family of four with two children				
Half-time minimum wage	$5,350	$2,140	$535	$321
Full-time minimum wage	$10,700	$3,888	$972	$583
Wages equal federal poverty line	$17,600	$2,854	$714	$428
Wages equal 150% of poverty line	$26,300	$1,022	$256	$153
Family of three with one child				
Half-time minimum wage	$5,350	$1,819	$455	$273
Full-time minimum wage	$10,700	$2,353	$588	$352
Wages equal federal poverty line	$13,700	$2,192	$548	$329
Wages equal 150% of poverty line	$20,600	$1,089	$272	$163

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family of four is roughly $3,700 higher than for a family of three. Moreover, while the poverty line increases with family size, the federal credit provides no additional adjustment for larger families; the EITC makes no distinction between families with two children and families with three or more children.

Because wages do not adjust for family size, larger low- and moderate-income working families often fall further behind an adequate standard of living than smaller families with the same number of workers. Adjusting a state EITC for family size beyond the federal family-size adjustment thus can help larger working families keep pace with the cost of basic living expenses.

In most states with an EITC, the state EITC is set at the same percentage of the federal credit for all family sizes. In these states, the state EITC does not alter the family-size differential in the federal credit.

Wisconsin takes a different approach and varies its state EITC by family size. The Wisconsin EITC is set at four percent of the federal credit for families with one child, 14 percent for families with two children, and 43 percent of the federal credit for families with three or more children. This approach directs a greater share of EITC benefits to large families, while adding only modestly to the credit's complexity. Because large families are a modest share of all EITC-eligible families, Wisconsin's approach does not necessarily make the credit more costly. The average Wisconsin EITC benefit is roughly 18 percent of the federal credit, a level well within the range of other refundable state EITCs.

Local Earned Income Tax Credits

Like states, local governments may enact Earned Income Tax Credits. In 1999, two major local governments passed legislation to create refundable Earned Income Tax Credits. In New York City, the City Council passed and the mayor signed a bill to allow a refundable credit equal to five percent of the federal credit to be claimed on the New York City income tax form, which is a separate form from the state income tax form. The state legislature, however, did not enact the necessary enabling legislation to allow the credit to take effect.

Montgomery County, Maryland, a large suburban county adjoining the District of Columbia, enacted a refundable EITC in 1999. The credit was enacted in response to growing concerns about the large number of working poor families in the county and the difficulty of making ends meet in a jurisdiction with a high cost of living. The credit equals the state's refundable credit, which in 1999 equals 10 percent of the federal credit.

Although Maryland counties levy an income tax based on the state income tax, at the time the credit was passed they did not have statutory authority to change the state tax form to allow county residents to claim county tax credits. In order to provide the credit, the county initially contracted with the state comptroller's office — which administers the tax system — for the comptroller to identify each county family that claimed the state EITC and send them an additional check to be paid from county funds. As a result, county taxpayers did not have to fill out any additional paperwork to claim the county EITC. More than 12,000 Montgomery County taxpayers received credits of up to $400 when the first payments were mailed out in January, 2000. The state subsequently passed legislation to allow inclusion of county EITCs on the state's tax form.

Both New York City and Montgomery County are localities that levy income taxes. It should be noted, however, that the approach taken by Montgomery County and the state of Maryland to implement the county EITC does not depend on the local jurisdiction having an income tax. It could be used to implement a local EITC in any state with a state EITC.

Workers Without Qualifying Children

Another decision that must be made in designing a state EITC is whether or not to extend the credit to low-income workers who do not have a qualifying child living with them. Such workers between the ages of 25 and 64 were made eligible for a modest federal EITC for the first time as part of the 1993 expansion.

On one hand, workers without qualifying children generally receive only small amounts from a state EITC. For example, in a state with an EITC established at 15 percent of the federal credit, the maximum state credit for a worker without a qualifying child is $53. Thus, some low-income workers without a qualifying child may find a state credit not worth the effort required to claim it, particularly if they owe no state income tax and are not otherwise required to file a state tax return. On the other hand, the cost of including workers without qualifying children in a state EITC is likely to be small, and some people are helped by it.

Ease of administration may be the key factor in a decision whether or not to include workers without a qualifying child in a state EITC. Excluding workers without qualifying children from a state EITC requires additional instructions on state tax forms, and it is likely that some workers without children miss the instructions and claim the credit anyway. At the same time, states may face an increase in the number of returns it must process if a refundable state EITC is extended to these residents, since federal EITC recipients without qualifying children have very low incomes and in many states owe no income tax.

At present, New Jersey, Wisconsin and Maryland are the only states in which workers without qualifying children are excluded by statute from their refundable EITCs. Maryland's non-refundable credit covers workers without qualifying children, but workers with incomes low enough to qualify for the non-refundable credit generally do not owe Maryland income tax and thus do not derive any benefit from the Maryland EITC.

V. Financing a State Earned Income Credit

Understanding the potential costs of a state EITC is important, because any such proposal will be considered in the context of the state's budget situation. State EITCs have been financed in a variety of ways: for example, from surplus General Fund dollars available due to revenue growth; from additional revenue generated by tax increases; or from funds freed up by forgoing other less well-targeted tax cuts. A new option for financing part of the cost of a refundable state EITC is to use funds made available through the federal welfare block grant; this option is discussed below.

Estimating the Cost of a Refundable State EITC

There is a simple three-step method to approximate the cost of a refundable state EITC that is set at a percentage of the federal credit. The esti mating procedure makes use of two sets of data. The first set is published Internal Revenue Service data on the amount of federal EITC claims filed by residents of each state. The most recent full-year data, shown in the second column of the table in Appendix II, are for claims made in 1999. These claims are for tax year 1998, meaning that the claims were based on 1998 earnings. All but a tiny fraction of EITCs are claimed and paid when taxes are filed in January through April of the following year, in this case in early 1999. As a result, nearly all of the cost for tax year 1998 EITCs is incurred in federal fiscal year 1999. In most states, the cost of tax year 1998 claims would fall in state fiscal year 1998-99 as well.

The second data source is U.S. Department of Treasury projections of the cost of the federal EITC in future years. Due to current low unemployment, low inflation, and increasing wages, Treasury projects that the cost of the federal EITC will grow from $30.46 billion in federal fiscal year 1999 to $31.861 billion in federal fiscal year 2002, an average annual growth

rate of 1.5 percent. After fiscal year 2002, annual growth is expected to increase to 3 percent to 4 percent (see table on this page).[20]

Using these data, the cost of a refundable state EITC in fiscal year 2002 is relatively easy to estimate.

Step 1: Estimate the total amount of federal *EITC claims in a given state for a future fiscal year.*

The cost of the federal EITC in a state in a future fiscal year may be determined by calculating the share of the federal EITC attributable to the state in the base year and using that share to project the cost of the federal EITC in the state in a future year. For example, in 1998, Alabama EITC claims totaled $784 million, or 2.54 percent of nationwide EITC claims for that tax year. Assuming that Alabama's share of federal EITC claims remains approximately constant, Alabama's federal EITC claims in fiscal year 2002 may be expected to equal 2.54 percent of $31.86 billion, or $815 million, as shown in the fourth column of the table in Appendix II.

U.S. Treasury Projections of Federal EITC Costs

Fiscal Year	Cost (millions)
1999	$30,457
2000	$30,376
2001	$30,589
2002	$31,861
2003	$32,843
2004	$34,141
2005	$35,462

Source: *Budget of the United States Government, FY 2001*, Table 32-4.

Step 2: Multiply federal claims by the percentage at which the state credit is to be set.

If the state EITC is set at a specified percentage of the federal EITC, the cost of the federal credit in the state, as determined in Step 1, should be multiplied by the percentage rate. This yields an estimate of what the state credit would cost in a given fiscal year if everyone who receives the federal credit also receives the state credit.

Step 3. Adjust the estimate for the fact that not all federal EITC claimants will claim the state credit in the first few years.

In practice, a substantial portion of federal EITC claimants fail to claim state EITCs, especially in the first few years after enactment of the state credit.[21] This appears to be true for

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[20] Until 1996, both the number of EITC beneficiaries and the cost of the federal EITC grew rapidly for a number of years as EITC expansions approved by Congress were phasing in. Since 1997, high EITC growth has ended and is not likely to resume. Independent projections from the Congressional Budget Office and from the congressional Joint Committee on Taxation each suggest comparable growth rates to the Treasury projections.

[21] Compared to the cost each state would have incurred if every family claiming the federal credit also claimed

(continued...)

several reasons. Awareness of the credit may be limited in the first few years after enactment of the state credit. In addition, some eligible families have the IRS compute their federal credit; such families may not receive a state EITC if the state does not compute the state credit amount for them. For these and other reasons, the cost of a refundable state EITC in its initial years after enactment is likely to be lower than the full cost of the federal credit multiplied by the state percentage. To reflect this difference, the estimate should be reduced by a factor of approximately 15 percent.

The last two columns of the table below show the estimated costs of refundable state EITCs set at either 10 percent or 20 percent of the federal credit in FY 2002, based on the method described above. Other percentages may be calculated based on those numbers (for instance, the cost of a 15 percent credit would be one-and-a-half times the cost of a 10 percent credit). The same method may be used for other years, using the projections of the federal credit shown in the table on the preceding page. None of these figures include the costs of changing tax forms to include a space to claim an EITC or the costs of processing and administering EITC claims; those costs are likely to increase the overall cost of the credit by less than one percent.

Financing State EITCs Through the Temporary Assistance for Needy Families Block Grant

There is an important new option for financing some of the cost of a refundable EITC. States, if they choose, may finance a portion of the cost by using federal funds from the Temporary Assistance for Needy Families block grant, or by counting some state funds expended for an EITC toward meeting the "maintenance of effort" required under TANF. This option was clarified by the U.S. Department of Health and Human Services in regulations issued in April 1999.[22]

States may use TANF or MOE funds only for *refundable* EITCs — that is, for credits that provide families a refund when the credit amount is greater than a family's income taxes. More specifically, states can count only the portion of an EITC that provides a refund in excess of tax

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[21] (...continued)
the state credit, the actual cost of a newly-enacted state EITC in its first year of availability was about 81 percent in Vermont, 83 percent in New York, 85 percent in Kansas and in Wisconsin, and 90 percent in Minnesota. In the second year of availability in each state, the cost in Vermont rose to 85 percent, the cost in New York rose to 90 percent and the cost in Minnesota rose to 93 percent relative to the full-participation cost. Similar research is reported in the fiscal note prepared by the North Carolina General Assembly's Fiscal Research Division on HB 952 in 1999 (see www.ncga.state.nc.us/html1999/bills/fiscalInfo/house/ hfn0952.pdf). After six years of implementation, one state, Minnesota, has achieved virtually 100 percent participation, but this participation level came only with the assistance of an aggressive state-funded outreach effort that at one point included mailing state EITC checks to those families that received the federal EITC but failed to claim the state EITC.

[22] 64 Federal Register 17719-17931 (April 12, 1999).

liability. In most states, the portion that can be counted is likely to equal at least one third and sometimes as much as nine-tenths of the total cost of a state EITC, depending on the specifics of the state's income tax code and the precise composition of its EITC-eligible population. State EITCs that are non-refundable — those that reduce or eliminate state income taxes that low-income families otherwise would owe but do not provide refunds in excess of tax liability — cannot be financed at all with federal funds and cannot count toward states' MOE requirements.[23]

Although many EITC recipients are not on welfare and have incomes above their states' welfare eligibility limits, states can still finance the refundable portion of a state EITC with TANF or MOE funds. The welfare law requires that TANF and MOE funds be spent on needy families, but states are allowed to set the definition of "needy." Moreover, states are allowed to set differing financial eligibility rules for different TANF- or MOE-funded programs. The state need only establish in its TANF state plan a program-specific income eligibility limit that would include all recipients of EITC refunds. Note that the federal "time limit" — the requirement that most adult welfare recipients may not receive federally funded welfare payments for more than 60 months in their lifetimes — and most other restrictions that attach to receipt of cash assistance under TANF do not apply to state EITC payments. As a result, using TANF or MOE funds to support the refundable portion of a state EITC would have no adverse consequences on EITC recipients.

Largely due to declines in welfare caseloads, some states have large amounts of unspent federal block grant funds.[24] In addition, some states are finding that their own-source traditional welfare expenditures are declining. States whose welfare expenditures decline by more than a specified amount can face substantial federal penalties and loss of funds. With an EITC, states can spend their federal funds or can count additional state funds toward the MOE requirement. For some of these states, financing a portion of a refundable EITC with TANF or MOE funds can be an attractive option.

The fact that refundable EITCs are a permissible use of welfare funds under the federal law, however, does not mean that method of financing is the right choice for every state. By choosing to finance its EITC entirely from non-welfare funds, a state can reserve welfare funds for other forms of assistance. For instance, a state may want to target its welfare funds more narrowly to the most needy families, such as those that are unable to find work due to disability or other factors; or it may want to spend the welfare funds to meet a particular need, such as child care. Or a state may determine that an EITC should be considered tax relief and therefore should be financed from the same general revenue sources as other forms of tax relief, as all states

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[23] The regulations also bar states from spending federal funds or state MOE funds on property tax credits, sales tax credits, or other tax credits that expressly offset tax liability. However, they permit states to spend those funds on the refundable portion of other work-related tax credits such as child care credits.

[24] Ed Lazere, *Unspent TANF Funds in the Middle of Federal Fiscal Year 2000*, Center on Budget and Policy Priorities, August 2000.

enacting EITC prior to the new welfare law have done. Nonetheless, for states seeking to expend welfare funds in ways that help families making the transition from welfare to work, the new federal regulations may offer an attractive financing option for an EITC.[25]

[25] For further explanation of the TANF regulations, see the Center on Budget and Policy Priorities publication *Highlights of the Final TANF Regulations*, April 29, 1999.

VI. Enacting a State Earned Income Tax Credit: Case Studies

One factor that makes a state Earned Income Tax Credit attractive as a strategy for assisting low-wage workers is its ability to generate support from policymakers and constituencies across the political spectrum. Examinations of how the Kansas EITC came to be adopted and how the Maryland EITC was expanded to include a refundable component illustrate the broad range of support that EITCs can generate.

Kansas: Cutting Taxes to Combat Poverty

Kansas enacted a state EITC in April 1998 as part of a tax cut package. Its passage reflects a desire to allow low-income families to share the benefits of the state's revenue surplus and to help families making the transition from welfare to work.

A refundable EITC was first considered by the Kansas legislature during the state legislature's 1997 session. A 10 percent refundable state EITC was included in an education bill passed by the state House of Representatives, but was taken out during conference committee.

Following the 1997 session, several factors led to increased support for an EITC. In September 1997, a coalition of human service advocates released a study entitled *Kansas Families: Poverty Despite Work*.[26] The report, which received substantial news coverage, showed that the vast majority of poor children in Kansas had working parents. The report included a state EITC as one of its major policy recommendations.

[26] The report was based on information in *The Poverty Despite Work Handbook*, Center on Budget and Policy Priorities, April 1997. An updated version of this handbook is scheduled to be published in early 2001.

The study's release coincided with the final deliberations of a bipartisan interim legislative committee to make recommendations on tax policy. Faced with a substantial budget surplus and mounting political desire to cut taxes, the committee considered a number of possible tax cuts. At the urging of committee member Bruce Larkin, a Democratic House member, the committee included an EITC in its final recommendations. The recommendations cited, among other reasons, Kansas' relatively heavy income tax burden on working poor families.

With the encouragement of the interim legislative committee and human services providers, Republican Governor Bill Graves included the EITC among a package of tax cuts in his 1998 budget submission and singled out the credit for praise in his State of the State address. In the State Senate, the Republican leadership ignored the governor's proposal and issued a tax package that included no assistance for working poor families. But the EITC was included in the tax bill crafted in the House of Representatives, also controlled by Republicans. "Kansas has numerous taxpayers who are below the poverty level who still must pay Kansas income taxes," Representative Phill Kline, the chairman of the Taxation Committee, wrote to the House Republican Caucus. "This is poor policy and the EITC corrects this problem." For a number of weeks, a House-Senate conference committee deadlocked over the tax bill, with the refundable EITC among the sticking points.

Supporters of the credit, including the Kansas Catholic Conference (which assigned a person to work full-time on the issue), United Community Services of Johnson County, Kansans Respond, and Kansas Action for Children, stressed the importance of making the credit refundable in order to ensure that benefits reached a large number of poor children. The fact that Kansas levies a sales tax on food — a tax that is particularly burdensome on low-income families — helped underscore the point that a refundable credit would offset other taxes paid by the poor. In addition, the governor's office distributed to legislators research showing that the EITC actually induces single mothers to work and therefore may reduce welfare spending.

One issue that arose during debate over the tax bill was the extent to which ineligible families claim the EITC. In response, advocates presented analysis explaining that many EITC errors reflect honest mistakes and highlighted new federal initiatives that hold promise for reducing EITC errors.[27]

The House-Senate deadlock was broken in April, when a higher-than-anticipated revenue estimate persuaded legislative leaders that the state could afford the major tax provisions in both the House and Senate bills. The governor submitted another tax plan that included a refundable EITC, and this time both houses passed it without changes.

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[27] Two publications from the Center on Budget and Policy Priorities contain further discussion of EITC error rates: *The Earned Income Tax Credit and Error Rates*, February 25, 1998, and *State Earned Income Tax Credits and Error Rates*, February 18, 1998.

Maryland: An Emphasis on Refundability

Maryland's refundable EITC, enacted in 1998, is unique in that it complements a previously existing non-refundable EITC. The non-refundable credit is an important source of tax relief for families with incomes somewhat above the poverty line.[28] Poorer families, however, would not owe income taxes even without the credit (due to other features of the income tax) so the existence of the non-refundable credit does not benefit those poorer families. By contrast, a refundable credit would benefit all working poor and near-poor families with children.

The effort to enact a refundable credit began in late 1996, when advocates from the Maryland Catholic Conference and the Homeless Persons Representation Project began discussing how to correct this lack of refundability. The existing non-refundable credit is set at 50 percent of the federal credit, higher than any other state EITC. As a result, the cost to the state treasury of making the full 50 percent credit refundable was judged to be prohibitively expensive. On the other hand, repealing the existing credit and replacing it with a smaller, refundable credit would result in a tax increase for many moderate-income taxpayers. The solution was to seek a smaller refundable credit equal to 15 percent or 20 percent of the federal credit that taxpayers could choose as an alternative to the larger non-refundable credit.

The EITC did not get much consideration in the 1997 legislative session. The legislature's attention was focused on a proposal to reduce Maryland's income tax rate by 10 percent. As proposed by Governor Parris Glendening, a Democrat, the tax cut would have largely benefitted upper-income taxpayers. It also was quite expensive and so was projected to require major cuts in public services. Many potential EITC supporters among human service advocates therefore concentrated their efforts on making the tax cut smaller and less weighted toward the top. These efforts were partially successful. As finally passed in spring 1997, the benefits of the tax cut were more equally divided among middle- and upper-income taxpayers than in the governor's proposal, and revised revenue estimates showed that the tax cut would not require spending cuts as deep as had been anticipated. In the intense debate around the tax cut, however, the refundable EITC was set aside.

Following adjournment of the legislature, backers of the refundable EITC expanded their campaign. A formal coalition was formed, with members including the Maryland Committee for Children — a longtime participant in successful outreach partnerships to help low-income workers claim the federal EITC — plus Catholic Charities, the Maryland Food Committee, and a number of other organizations. The chairs of the Senate and House tax-writing committees, Senator Barbara A. Hoffman and Delegate Sheila Hixson, agreed to sponsor the bill. The state NAACP and members of the legislature's Black Caucus and Women's Caucus added their

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[28] A description of how the non-refundable Maryland credit came to be enacted in 1987, as well as case studies from New York and Wisconsin, may be found in the Center on Budget and Policy Priorities publication *A Hand Up: How State Earned Income Credits Help Working Families Escape Poverty, 1996 edition.*

support. The coalition also secured support from major private corporations including two of the state's largest employers, Baltimore Gas and Electric Company and Bell Atlantic. Fully half of the state's Senators and one-fourth of members of the House of Delegates were cosponsors by the time the bill was filed early in the 1998 legislative session.

Supporters of the credit released two important reports, one showing that income inequality in Maryland was on the rise and another, similar to the Kansas report, showing that large numbers of low-income children in Maryland live in working families. They also stressed the usefulness of the EITC as an inducement for work and a complement to welfare reform, and pointed out that the EITC would accomplish what the previous year's income tax cut had not, namely providing a share of the tax reductions to low-income families. The state's major newspaper, the *Baltimore Sun*, endorsed the EITC in an editorial.

Opposition to the credit in 1998 came from the state's comptroller, who expressed concern about complexity and the potential for fraud. But the fact that Maryland already had a non-refundable credit helped to mute those concerns, and one key legislator pointed out during a hearing that the EITC was less susceptible to fraud than other parts of the tax system.

The General Assembly passed the EITC bill toward the end of the legislative session, and the governor signed it. As in Kansas, the final boost for the credit came in the form of a higher-than-expected revenue estimate, which enabled the state to enact a number of tax cuts. To moderate the fiscal cost of the credit, legislators chose to start the credit at 10 percent of the federal credit for tax years 1998 and 1999, rising to 12.5 percent for 2000 and to 15 percent for 2001 and thereafter. Legislators also agreed to language specifying that the credit should be phased in more rapidly if state revenue growth remained strong. In 2000, the state did accelerate the phase-in of the credit to 15 percent.

APPENDIX I:
Federal Earned Income Tax Credit Parameters

There are different EITC parameters for families with one child, for families with two or more children, and for workers without qualifying children. The parameters are adjusted for inflation each year, in the same way that the exemptions, deductions and tax benefits in the federal tax code are adjusted. The EITC parameters are listed below for 2000 (as published by the Internal Revenue Service) and 2001 (as calculated by RIA Tax, a private firm; the IRS is scheduled to publish the official 2001 parameters in December 2000).

Year	Credit Percentage	Maximum Benefit	Phase-out Rate	Phase-out Range
Families with two or more children:				
2000	40% of first $9,720	$3,888	21.06%	$12,690 to $31,152
2001	40% of first $10,020	$4,008	21.06%	$13,090 to $32,121
Families with one child:				
2000	34% of first $6,920	$2,353	15.98%	$12,690 to $27,413
2001	34% of first $7,130	$2,424	15.98%	$13,090 to $28,260
Families with no children:				
2000	7.65% of first $4,610	$353	7.65%	$5,770 to $10,380
2001	7.65% of first $4,760	$364	7.65%	$5,950 to $10,708

Sources: Internal Revenue Service tax tables for 2000; RIA Tax estimates for 2001.

APPENDIX II:

Estimated Cost of Refundable State Earned Income Tax Credits

(dollars in millions)

State	Federal EITC claims, TY 1998	Percent of total U.S. claims	Cost of Federal EITC in FY 2002 (estimated)	Estimated Cost of State EITC in FY 2002	
				Set at 10% of Federal Credit*	Set at 20% of Federal Credit*
Alabama	$784	2.54%	$811	$69	$138
Alaska	40	0.13%	42	4	7
Arizona	557	1.81%	576	49	98
Arkansas	426	1.38%	440	37	75
California	3,800	12.33%	3,929	334	668
Colorado	338	1.10%	349	**	**
Connecticut	208	0.67%	215	18	37
Delaware	78	0.25%	80	7	14
District of Columbia	82	0.26%	84	**	**
Florida	2,048	6.65%	2,117	180	360
Georgia	1,192	3.87%	1,232	105	209
Hawaii	88	0.29%	91	8	15
Idaho	129	0.42%	133	11	23
Illinois***	1,161	3.77%	1,200	102	204
Indiana	554	1.80%	573	49	97
Iowa***	213	0.69%	220	19	37
Kansas	221	0.72%	228	**	**
Kentucky	466	1.51%	482	41	82
Louisiana	865	2.81%	894	76	152
Maine***	115	0.37%	119	10	20
Maryland	495	1.61%	512	**	**
Massachusetts	386	1.25%	399	**	**
Michigan	858	2.78%	887	75	151
Minnesota	306	0.99%	316	**	**
Mississippi	637	2.07%	658	56	112
Missouri	601	1.95%	622	53	106
Montana	98	0.32%	101	9	17
Nebraska	139	0.45%	144	12	24
Nevada	184	0.60%	190	16	32
New Hampshire	77	0.25%	80	7	14
New Jersey	675	2.19%	698	**	**
New Mexico	286	0.93%	295	25	50
New York	2,006	6.51%	2,074	**	**
North Carolina	1,036	3.36%	1,071	91	182
North Dakota	53	0.17%	55	5	9
Ohio	1,040	3.37%	1,075	91	183
Oklahoma	452	1.47%	468	40	80
Oregon***	299	0.97%	309	26	53
Pennsylvania	1,016	3.30%	1,050	89	179
Rhode Island***	84	0.27%	87	7	15
South Carolina	625	2.03%	646	55	110
South Dakota	72	0.23%	74	6	13
Tennessee	766	2.48%	792	67	135
Texas	3,273	10.62%	3,384	288	575
Utah	167	0.54%	172	15	29
Vermont	49	0.16%	51	**	**
Virginia	688	2.23%	711	60	121
Washington	447	1.45%	463	39	79
West Virginia	209	0.68%	216	18	37
Wisconsin	365	1.19%	378	**	**
Wyoming	48	0.15%	49	4	8
U.S. Total	**$30,812**	**100.00%**	**$31,861**		

* Estimates of state EITCs assume participation rate equal to 85 percent of federal participation; see text for discussion.

** State already has refundable state EITC

*** For Illinois, Iowa, Maine, Oregon and Rhode Island, cost shown is the total cost of a refundable credit; since those states already offer non-refundable credits, the added cost of making the credit refundable would be substantially less than the amount shown here.